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SUBJECT: ARGENTINA ECONOMIC AND FINANCIAL REVIEW, NOVEMBER 2008

¶11. (U) Provided below is Embassy Buenos Aires' Economic and Financial Review covering November 2008. The unclassified email version of this report includes tables and charts tracking Argentine economic developments. Contact Econoff Chris Landberg at landbergca@state.gov to be included on the email distribution list. This document is sensitive but unclassified. It should not be disseminated outside of USG channels or in any public forum without the written concurrence of the originator. It should not be posted on the internet.

HIGHLIGHTS

--President Kirchner announces plan to foster growth, employment, capital repatriation
--GoA on the Verge of Expropriating Aerolineas Argentinas?
--Congress set to extend the Emergency Economic Law and Financial Transaction Tax (FTT)
--Congress approves 2009 Budget Bill
--October Trade surplus at \$1.1 billion, flat versus a year ago
--GoA responds to summer season's first power outages with natural gas tariff increases
--INDEC underreporting continues despite slowing inflation: October CPI up 0.4% m-o-m, the lowest increase of the year
--Industrial production decelerates in October
--FIEL foresees a dark and tough future for Argentina's economy

NEW GOA FISCAL PROGRAM

President Kirchner announces plan to foster growth, employment, and capital repatriation

¶12. (SBU) In a November 25 presentation before the powerful UIA (Argentine Industrial Union), President Cristina Fernandez de Kirchner announced plans to submit a bill to Congress proposing tax incentives to foster job creation and encourage the repatriation of funds held by Argentine individuals and companies abroad (estimated at over US\$130 billion). The GoA sent this package of measures to Congress the same day. Highlights:

-- Companies creating new jobs will receive a 50% tax break on labor contributions for each new hire in the first year;
-- Companies regularizing "informal" employees will be forgiven past tax owed on these employees;
-- Companies or individuals declaring funds held abroad to the local tax authorities (AFIP) but choosing to keep them abroad would be charged an 8% tax rate, whereas repatriated funds will face a 6% tax if the funds are put in the local financial system without any specific investment allocation, or 3% tax if the funds are invested in bonds, or 1% tax if the funds are invested in real estate, infrastructure, or agricultural or industrial ventures.

-- Splitting off a new Ministry of Production from the existing Ministry of Economy and Production. The new Ministry will focus on the promotion of Argentine production and exports. (The President subsequently appointed current Production Minister for Buenos Aires Province, Debora Giorgi, as the new Minister of Production.)

¶ 13. (SBU) Later on November 25, during a dinner presentation at the Argentine Construction Chamber, the President announced the launching of a 71 billion peso (roughly US\$ 21bn or about 6% of estimated 2008 GDP) public works program, designed to stimulate the economy and mitigate the effects of the global financial crisis on the local economy. The President predicted that the plan would more than double the number of jobs in the construction sector, and said complete details will be unveiled December 15. According to local press, the plan will be implemented over three to five years.

¶ 14. (SBU) Industrial and construction leaders loudly applauded the announcements, and several of Post's contacts among economists and bankers who are normally critical of GoA economic policies praised the pro-business tone of the President's initiatives. Nevertheless, most foreign and domestic analysts appear skeptical of their impact, predicting in their published critiques that the measures will have limited affect on economic activity and are not sufficient to counteract the precipitous fall in demand and production. They also questioned how the GoA will finance the public works plan, given that it has no access to credit and is facing the prospect of lower than expected revenues in 2009. Many analysts also emphasized that the measures do no address the main challenge facing the economy, namely the lack of credibility of GoA economic policies.

CIVIL AVIATION

GoA on Verge of Expropriating Aerolineas Argentinas?

¶ 15. (SBU) According to press reports and industry representatives, the ruling party in Congress is preparing the legislative groundwork for the expropriation of Spanish-owned flagship airline Aerolineas Argentinas (AA) and sister carrier Austral. A vote could come before the end of the year. The press quotes the draft bill as stating "We cannot accept that public air transport in Argentina continues in the hands of a company that operates with notable incompetence," and also declaring the company "of public utility and subject to expropriation."

¶ 16. (SBU) AA's owner, Spanish travel group Marsans, agreed in principle July 17 to sell both airlines to the GoA, after which the GoA took over operational control (with formal transfer pending resolution of the purchase price). The press reports that the GoA has since spent about \$220 million to pay Aerolineas and Austral's payroll and operating expenses. As part of the July agreement, each side pledged to determine a value for the companies, or submit to third party review if they could not agree on the purchase price. The GoA's Valuation Tribunal estimated the value at negative US\$ 832 million. Marsans contracted Credit Suisse to assess the airlines' value, which it established at US\$ 330-540 million. Congress subsequently disallowed any third-party review, and indicated that it alone would fix the price. Leading members of Congress were quoted in the press stating the GoA should not pay anything for the carriers, or even that Marsans should pay the GoA for taking it over.

¶ 17. (SBU) Money hemorrhaging continues: Aviation analysts and media reports estimate AA's daily losses at about US\$ 1.5 million, or about US\$ 700 million annually. These same analysts say that AA's 9,200 employees represent an employee per plane ratio of about 344, far higher than the industry average of about 60-100. Media and Embassy industry contacts report that in the run-up to the 2009 congressional elections, the GoA may hire even more. AA has been plagued by workers' strikes, flight delays, and cancellations for months, and the GoA says it has a debt load of nearly US\$ 900 million. AA was on the verge of bankruptcy in 2001 when Marsans bought it from Spanish holding company SEPI. AA and Austral operate about 80% of domestic flights in Argentina.

FISCAL

Congress set to extend Emergency Economic Law and Financial Transaction Tax (FTT)

¶ 8. (SBU) The Argentine Chamber of Deputies passed the one-year extension (until Dec. 2009) of the controversial Economic Emergency Law November 26 (134 positive votes against 95 opposed) over strong criticism from the opposition. This law delegates legislative powers to the executive branch and allows the President to enact a wide range of economic policies by decree (e.g., debt and utility tariff renegotiation, extend social assistance plans, implement measures to foster employment and growth). Background: the Economic Emergency Law was first approved in January 2002 during President Duhalde's administration and has since been extended five straight years, despite opposition arguments that after five consecutive years of over 8% real GDP growth the country is no longer in a state of emergency. This year, however, the GoA cited the deteriorating international economic environment in its justification of the extension.

¶ 9. (SBU) Along with the Emergency Economic Law, the lower house also approved a one-year extension (also until Dec. 2009) of the FTT (financial transactions tax) on November 26, and forwarded it to the Senate for approval. The FTT 2009 annual collection is budgeted at ARP 22 billion, of which 70% goes for the federal Treasury and the remaining 30% to the provinces. Opposition Deputies called for the equal sharing of the tax with provinces. Background: the FTT was first introduced in 2001 by then-Minister of Economy Domingo Cavallo and since then been extended every year, despite criticism that it discourages financial intermediation in an already undersized domestic financial market. However, the GoA highly values this tax for its ease of monitoring and collection, and the extension is a priority for the GoA given expectations that overall tax revenues will decline significantly in 2009 due to the decelerating economy and lower sliding commodity prices. The Senate Budget Committee started debating both bills December 2, with Senate approval expected around the middle of the month.

Congress approves 2009 Budget Bill

¶ 10. (SBU) After an eight-hour debate, the Senate overwhelmingly approved the 2009 budget bill on November 5 (48 positive votes vs. 14 negative ones) without amendments and over the strong criticism from the opposition (which argued that the bill does not reflect the current economic reality). The Chamber of Deputies had already approved the bill October 16, also without making changes to the version the Executive sent to Congress on September 15. The law was published in the Official Gazette on November 21 and entered into force by the end of the month.

¶ 11. (SBU) During the Senate debate, opposition criticism focused on three issues: 1) the outdated macroeconomic assumptions of the budget, which for the first time in five years may prove overly optimistic, particularly with regards to GDP growth, inflation, and prices of Argentina's main commodity exports; 2) the granting of so-called "superpowers" to the GoA, which they argued renders the budget meaningless, given that it allows the Chief of Cabinet to reallocate expenditures without Congressional approval; and 3) the failure to include the revenues the GoA will receive as a result of the nationalization of the private pension fund system (which the Senate approved November 20 and will enter into force in early to mid-December). Highlights of the 2009 budget bill:

-- GDP growth of 4%, which may prove accurate or even optimistic, given most private analysts' estimates of rapidly decelerating economic activity in Argentina. (Note: in past years the GoA has estimated growth of 4%, whereas actual growth has exceeded 8%. This serial underestimation has lead to large inflows of unbudgeted tax revenues, which the GoA has been able to redirect with minimal congressional oversight using "superpowers.")

-- CPI of 8%, compared to private estimates of about 20%;
-- An average exchange rate of 3.19 ARP/USD, already outdated given the current exchange rate of 3.35 ARP/USD. (Many private analysts estimate the peso will end 2009 in the range of 3.80-4.00 USD.)

-- Primary fiscal surplus of 3.27% of GDP, compared to the primary surplus of 3.15% of GDP included in the 2008 budget. The budgeted primary fiscal surplus may be difficult to obtain, given the

expected deceleration of revenues and falling commodity prices of Argentina's key exports.

-- A trade surplus of \$12 bn, the result of \$78 bn exports and \$66 bn imports. (The 2007 trade surplus was \$11.2 bn and is estimated at \$12 bn for 2008, according to the latest BCRA consensus survey.) However, private estimates of the 2009 trade surplus are sharply lower, ranging from zero to \$6-8 bn, reflecting rapid increases in imports and falling commodity prices.

-- An ARP 3 billion cut in subsidies (over a 10% drop compared to 2008 subsidies of about ARP 35 billion).

-- An estimated 25% increase in pension payments, representing increased expenditures of about 10bn pesos.

¶12. (SBU) The bill includes two controversial articles, which increase the GoA's ability to borrow from state-owned Banco de la Nacion (BNA) and from the Argentine Central Bank (BCRA). The change to the BCRA's Charter allows short-term lending to the GoA for foreign currency payments, whereas before these funds could only be used to pay debts to international financial institutions. In theory, the GoA can now use BCRA funds to pay sovereign debt obligations coming due in 2009/2010. The amendments to the BNA's Charter allow the GoA to borrow funds to finance capital expenditures and debt repayments up to a limit of 30% of the GoA deposits held at the BNA. This type of financing was previously prohibited under the BNA's Charter.

TRADE

October Trade surplus at \$1.1 billion, flat versus a year ago

¶13. (SBU) Official GoA statistics released November 25 show that Argentina's goods trade surplus in October 2008 was virtually identical to the surplus in October 2007, despite substantial month-on-month growth in the surplus throughout the first nine months of 2008. The October 2008 surplus, according to statistics agency INDEC, was \$1.133 billion, just 0.8% more than the \$1.124 billion surplus in October 2007. This contrasts sharply with total surplus growth in 2008, which - including October - had risen 38% y-o-y. The September 2008 trade surplus of \$1.67 billion was 95% higher than the surplus one year before. Imports and exports in October were both up y-o-y (16.6% and 13.4%, respectively), but by less than rates earlier in the year.

¶14. (SBU) Planning Minister Julio De Vido announced the same day new GoA trade estimates for 2009 predicting that exports will decline 16% in value terms compared to 2008 (to an estimated \$56 billion) and the overall trade surplus will fall to \$7 billion. He attributed the declines to lower commodity prices. The total trade surplus through October 2008 was \$11.4 billion, after a surplus of \$11.1 billion for all of 2007. Private analysts' 2009 trade surplus estimates range from flat to a surplus of \$8 billion, with this latter figure seeming optimistic compared to the GoA's own estimate of \$7 billion. The latest BCRA consensus survey estimates a \$12 billion and \$6 billion trade surplus for 2008 and 2009, respectively.

ENERGY

GoA responds to summer season's first power outages with natural gas tariff increases

¶15. (SBU) Once again, the first heat wave of summer has exposed Argentina's fragile energy situation. People turning on their air conditioners to deal with the high temperatures increased electricity demand and strained the power grid, triggering blackouts in several areas of Greater Buenos Aires. Power cuts last week affected approximately 45,000 people and even led to street protests in Buenos Aires against the GoA. Planning Minister Julio De Vido publicly apologized for the electricity cuts and said the GoA would initiate investigations through the energy regulatory agency to impose sanctions on the energy firms (presumably distribution companies) that failed to fulfill their distribution contracts.

¶16. (SBU) According to local press reports, De Vido also made a

number of announcements on November 28, including an ARP 1.4 billion cut in the subsidies on natural gas (the main input for the generation of Argentine electricity) and a retroactive increase in natural gas rates charged to the biggest industrial, commercial, and residential users. (Energy subsidies totaled approximately US\$ 12 billion in the Jan-Sep 2008 period.) De Vido said that the increase would be 10% for industrial and commercial users and would only affect 1.5% of companies. In the case of residential users, the increase would be between US\$ 3 and US\$ 31 per month, and would only affect the top 36% of consumers (households consuming over 1000 cubic meters per year). This announcement followed a 20% increase in natural gas transportation and distribution rates in September 2008, and is the fourth increase in natural gas tariffs in the last four months. De Vido also stated that the increases would be passed through to natural gas well-head prices to promote investment in exploration and production, which will also result in higher royalty collection for producing provinces. (The press reported that De Vido estimated potential new investment in the range of US\$ 250 million.)

INFLATION

INDEC underreporting continues despite slowing inflation: October CPI up 0.4% m-o-m, the lowest increase of the year

¶17. (SBU) National statistics agency INDEC announced November 11 that October CPI was 0.4% m-o-m, the lowest of the year, but still below market expectations of 0.6% m-o-m as measured in the BCRA consensus survey. The CPI decelerated slightly to 8.4% y-o-y in October from 8.7% y-o-y in September. The 0.4% increase is due mainly to price increases for home appliances, clothing, transportation, and leisure activities. According to INDEC, the CPI accumulated an increase of 6.5% for the first ten months of the year, compared to private estimates of 15-20%. Private estimates for 12-month inflation (through October) are in the 15-20% y-o-y range, compared to the official INDEC estimate of 9.3% y-o-y. Anecdotal evidence suggests inflation is easing due to the slowdown in economic activity; and thus, the difference between "published" INDEC data and "true" inflation is likely shrinking. However, even with inflationary pressures easing, "true" monthly inflation still remains above the figure reported by INDEC. For the moment, there are no signs that the GoA will take advantage of this new scenario to make a smooth convergence to the true inflation of official CPI. INDEC also reported that Wholesale prices (WPI) increased 0.5% m-o-m in October, accumulating an increase of 9.4% in the first ten months of 2008.

MACRO OUTLOOK

Industrial production decelerates in October

¶18. (SBU) INDEC reported November 21 that Industrial production (IP) in October decreased 1.9% m-o-m, seasonally adjusted, and increased 2.6% y-o-y. The announcement disappointed the market, which had anticipated a 4.6% y-o-y increase. In the first ten months of the year, the IP increased 5.9% y-o-y compared to 7% during the same period last year. According to private analysts, the soft and disappointing October reading was the result of domestic and international factors, including tighter credit conditions, a stronger currency compared to trading partners, sustained capital flight and uncertainty, slower global growth, and sliding commodity prices. According to the last release of the BCRA consensus, IP is estimated to increase 7.1% in 2008 and fall by almost half to 4.2% in 2009. Within the index, four out of the twelve sub-sectors measured decreases, with the hardest hit being plastics (down 11% y-o-y) and textiles (down 10% y-o-y), while the sub-sectors with the largest increases were non-metallic minerals (cement, glass, and other construction materials, up 10% y-o-y), tobacco (up 9% y-o-y) and food and beverages (up 7% y-o-y).

FIEL foresees a dark and tough future for Argentina's economy

¶19. (SBU) This item outlines the main points from the FIEL Chief Economist's monthly presentation (Buenos Aires-based Latin American

Economic Foundation -- FIEL -- is a highly regarded, independent Argentine think tank devoted to economic and social research on Argentina and Latin America).

-- Recession: FIEL's own IP index dropped 2.5% y-o-y in October, compared to the official report of a 1.9% decrease (see above item).

This, according to FIEL's analysis of the numbers, is an indication that the risk of recession in 2009 is growing. In the first ten months of 2008, FIEL's IP index increased 4.3%, with only three sectors (autos, food and beverage, and metals) contributing almost 90% of the increase. FIEL expects two of these sectors -- autos and metals -- to decline rapidly due to the fall in external and domestic demand.

-- Unemployment: contrary to the GoA's claim that the unemployment rate fell to 7.8% in the third quarter, from 8.1% in QIII 07 and 8% in QII 08, FIEL believes that there has not been any employment creation since the beginning of the year. FIEL estimates that unemployment will once again exceed 10% in 2009.

-- Inflation Decelerating: FIEL estimates that the CPI decelerated to an annual level of 19% as of October, (compared to levels above 25% in March), and it continued decelerating as of the first two weeks of November, which showed an annual rate of 18%.

-- Trade Balance: FIEL estimates that the trade surplus will fall to \$8 billion in 2009, compared to its estimate of \$13 billion for 2008, the result of falling commodity prices and sharp increase in imports. FIEL predicts the GoA will pursue all means possible, especially using non-tariff barriers, to limit imports, particularly from Brazil and China. The three key items to monitor, in order to assess the direction of Argentina's economy and exports, are: 1) Brazil's GDP (since Brazil's growth impacts Argentine exports, especially of autos); 2) the Brazilian Real, which has sharply depreciated making Argentine exports to Brazil less competitive; and 3) the price of soy (Argentina's single largest export).

-- Devaluation: the GoA does not appear willing to let the peso depreciate rapidly (as neighboring countries have done) from its current level of around 3.35 ARP/USD for fears of: 1) pass through to prices; and 2) a bank run on deposits. However, FIEL believes the BCRA may decide to let the peso slide, since it would help the GoA finance primary expenditures (due to increases in peso revenues from export taxes). Also, a large, one-time devaluation would help stop (or reduce) capital flight (by making the dollar more expensive). FIEL's economists argued that not letting the peso depreciate, or managing a gradual devaluation, will result in a sharper recession. Either alternative, they believe, will be costly in political terms.

WAYNE